BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

Opinions of the Court Below.

The opinion of the Board of Tax Appeals is reported in 42 B. T. A. 521 and appears at Pages 32-39 of the Record, and its decision appears at Page 39 of the Record.

The reported opinion of the United States Circuit Court of Appeals, Fifth Circuit, rendered on April 8, 1941, appears in 118 F. (2d) 791, and appears at Page 143 of the Record, and the judgment of the Circuit Court appears at Page 149 of the Record.

Grounds on Which Jurisdiction is Invoked.

A statement of the grounds of jurisdiction is contained in the petition. The judgment of the United States Circuit Court of Appeals affirmed the decision of the Board of Tax Appeals. Such judgment of the Circuit Court of Appeals was entered on the 8th day of April, 1941 (R. 143). A petition for rehearing was filed April 28, 1941 (R. 150) and same was denied May 10, 1941 (R. 157). Petition for certiorari is presented herein on the 6th day of June, 1941. Jurisdiction is invoked under Section 240(a) of the Judicial Code as Amended by the Act of February 13, 1925, c. 229, Section 1, 43 Stat. 938 (28 U. S. C. A. 347) (8 F. C. A. Title 28, Section 347), and under Section 641 (a) of the Internal Revenue Code (Feb. 26, 1926, c. 27, Sec. 1003 (a), 44 Stat. 110; June 7, 1934, c. 426, 48 Stat. 926) (26 U. S. C. A. Sec. 1141) (6 F. C. A. Section 641).

Statement of Case.

A statement of the case is contained under heading, "Statement of the Matter Involved" in the foregoing petition, Pages 2 and 3, and will not be repeated here. To fur-

ther clarify the statement especial attention is directed to the following appearing in the record:

(1) Petitioner secured by assignment the rights of J. M. Martin in an oil and gas lease, executed by Lewises, as to 1321 acres of land (R. 64).

(2) Original lessors conveyed prior to 1934 to third parties not interested here approximately an undivided one-third interest in the oil, gas and minerals and the right to receive royalties (but not the right to receive rentals or bonuses from future leases), as to the lands leased to Martin (R. 64).

(3) Petitioner operated its leasehold estate, drilling wells and producing and selling oil and gas (R. 61).

(4) April 17, 1934, petitioner acquired by deed from Lewis, et al. the fee title to the land and all remaining lessor interests still attached thereto in the minerals (R. 57). Feb. 1, 1935 petitioner contracted to dispose of its leasehold interest, and did dispose of it to International Petroleum Corporation for $365,000.00, $60,000.00 of which was for personal property, leasehold equipment, and fixtures, and so specified in the contract (R. 57). Petitioner concedes $2,650.00 of such $305,000.00 is not depletable.

(5) Petitioner has received out of production by its assignee, as its pro rata share of oil and gas produced from the leasehold assigned to International Petroleum Corporation since such assignment, a total of $97,858.64 through October sales 1939 (R. 60).

(6) Petitioner anticipated a large development of the property by its assignee, which expectation entered into the consideration for the transaction, the directors feeling they were selling the leasehold at less value than it had, but expecting to be recompensed out of its reserved interest by increased production (R. 31 and R. 61, 62).

(7) Petitioner had a capital investment in the oil and gas in place, and after the transaction with International Petroleum Corporation still had a capital investment in the oil and gas in place, and its assignee was obligated by privity of estate to pay it a pro rata share out of every barrel of oil produced (R. 64 (b), 64 (e), 64 (g)).

Specification of Errors.

I.

The Honorable Circuit Court of Appeals for the Fifth Circuit erred in denying petitioner percentage depletion on $302,350.00 of a $305,000.00 cash payment received by petitioner for assignment of its working interest in an oil and gas property, and such decision is contrary to the weight of authority.

II.

The Honorable Circuit Court of Appeals for the Fifth Circuit erred in holding that petitioner, "after selling outright for money its lease interest, still had an interest in the oil reserve as the successor in title of the lessor, but that is not the same thing as retaining a royalty in the transfer," because by acceptance of the assignment, by reason of privity of estate between lessors' assigns and lessee's assigns, petitioner's assignee was contractually bound to pay petitioner a share out of every barrel of oil produced from the lease, and petitioner secured by a form of legal relationship income derived from the extraction of oil in the form of additional or advance royalty on anticipated production, and such decision is contrary to the weight of authority.

III.

The Honorable Circuit Court of Appeals erred in holding that petitioner was not entitled to percentage depletion and

that "there is no room to say that the money in this transaction was paid as advance royalty and hence is depletable income arising from the operation of the oil wells," because such decision incorrectly interprets Section 23 (m) Revenue Act of 1934, (Sec. 23 (m), Internal Revenue Code, 1939), and Regulations 86, Art. 23 (m)-10, and is contrary to the weight of authority.

IV.

The Honorable Circuit Court of Appeals erred in failing to give effect to a rule of property established by the courts of Texas, holding that the reversionary interest in the 7/8ths minerals covered by an oil and gas lease is a taxable interest in land. The decision ignores the fact that petitioner had and retained an interest in the 7/8ths mineral estate conveyed to International Petroleum Corporation, to-wit, the reversion, regardless of whether or not petitioner's total interests in the oil and gas merged so as to make its transaction analogous to execution of a lease, and such decision is contrary to the weight of authority.

ARGUMENT.

Point I.

Summary:

The Circuit Court of Appeals erred in holding that petitioner was not entitled to take percentage depletion on the cash sum received by it for transfer of an interest in oil and gas property.

Referable to the Question—and Reason I, II, III, IV, and V in Petition and Specifications of error I, II, III, and IV in Brief:

For brevity and to avoid repetitions, the argument will proceed under Specification I, II, and III combined under this point.

Argument and Authorities Under Point I:

The relevant portion of the statutes involved herein, being Section 23 (m), Revenue Act of 1934, (Sec. 23 (m), Internal Revenue Code, 1939), are lengthy and are set out in the appendix hereto.

The decision and holding of the Circuit Court of Appeals was to the effect that petitioner, owner of the 7/8ths leasehold, and owner of the reversion thereof, and also owner of a portion of the royalty reserved in the lease assigned, and of the entire fee in the land, did not have such an interest after assignment of the lease only as would entitle it to deplete the cash consideration as a bonus or advance payment of royalty.

This Court in *Murphy Oil Co.* v. *Burnet,* 287 U. S. 299, 53 S. Ct. 161, said:

> "We think it no longer open to doubt that when the execution of an oil and gas lease is followed by production of oil, the bonus and royalties paid to the lessor both involve at least some return of his capital investment in oil in the ground, for which a depletion allowance must be made under Sec. 234. See *Burnet* v. *Harmel, supra.* This is obvious where royalties are insufficient to return the capital investment. A distinction between royalties and bonus, which would allow a depletion deduction on the former but tax the latter in full as income, when received, making no provision for a reasonably anticipated production of oil on the leased premises, would deny the 'reasonable allowance for depletion' which the statute provides."

The text is amply supported by the authorities therein cited, and it is significant that the court used the language, "making no provision for a reasonably anticipated production of oil on the leased premises." The object of a lessor is to procure income from the removal of gas and oil from his premises. Petitioner had the same object and not only

a reasonable anticipation of production, but had by its own development made such anticipation a practical certainty, and it sought to have its land operated to produce such income by one more able to carry out larger development than it could do, and the one-eighth royalty provided in the lease was not a sufficient recompense to justify granting such operating rights to another, so it demanded and received an additional advance royalty in anticipation of such production, and its deal with International Petroleum Corporation secured to it, the just value of the use of its property which the fixing of the one-eighth royalty in the lease by Lewis was not adapted to give it, as said in *Works* v. *United States ex rel. Mosier,* 261 U. S. 252:

> "The bonus, which was the result of bidding for desirable oil and gas leases, secured for the members of the Osage Tribe the just value of the use of their property which the fixing of royalties in advance by the President was not adapted to give them. It was, in effect, a supplement to the royalties already determined. It was really a part of the royalty or rental in a lump sum or down payment. We do not see how it can be classified as anything else. It *was income from the use of the mineral resources of the land.* Of course, it involved a consumption and reduction of the mineral value of the land, but so does a royalty. This is an inevitable characteristic of income from the product of the mine."

In *Palmer* v. *Bender,* 287 U. S. 551, 53 S. Ct. 225, the Court said:

> "Both courts below followed the earlier decisions of the Court of Appeals with respect to the two assignments involved here and held that they were assignments of leases for stipulated considerations of bonuses paid and royalties to be received. The Government rested its case on this conclusion. It conceded that if

> any reversionary interest, according to common law, however small, had been retained in the leased land * * * the petitioner would be entitled to depletion as claimed."

Here, petitioner had a reversionary interest in the land which it retained. Also, its assignee, by virtue of privity of estate, was obligated by acceptance of the assignment, to pay to petitioner as lessors' assignee, the share of oil and gas production provided in the lease. (*Spencer's Case,* 1538, 5 Coke, 16a; *Pierce Fordyce Oil Ass'n* v. *Woodrum,* 188 S. W. 245; 3 Summers Oil & Gas, Permanent Edition 299, Sec. 553.)

In *Palmer* v. *Bender, supra,* the Court further stated:

> "The allowance to the taxpayer is not restricted by the words of the statute to cases of any particular class or to any special form of legal interest in the oil well. * * *. *The language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired by investment, any interest in the oil in place, and secures, by any form of relationship, income derived from the extraction of the oil, to which he must look for a return of this capital.* That the allowance for depletion is not made dependent upon the particular form of the taxpayer's interest in the property to be depleted was recognized by this court in *Lynch* v. *Alworth-Stephens Co.,* 267 U. S. 364 * * *. Similarly, the lessor's right to a depletion allowance does not depend upon his retention of ownership or any other particular form of legal interest in the mineral content of the land. IT IS ENOUGH IF BY VIRTUE OF THE LEASING TRANSACTION HE HAS RETAINED A RIGHT TO SHARE IN THE OIL PRODUCED. IF SO HE HAS AN ECONOMIC INTEREST IN THE OIL, IN PLACE, WHICH IS DEPLETED BY PRODUCTION. Thus we have recently held that *the lessor is entitled to a depletion allowance*

on bonus and royalties, although by the local law ownership of the minerals, in place, passed from the lessor upon the execution of the lease. * * *. Thus, throughout their changing relationships with respect to the properties, the oil in the ground was a reservoir of capital investment of the several parties, all of whom, the original lessors, the two partnerships and their transferees were entitled to share in the oil produced. Production and sale of the oil produced would result in its depletion and also in a return of capital investment to the parties according to their respective interests. The loss or destruction of the oil at any time from the date of the leases until complete extraction would have resulted in loss to the partnerships. Such an interest is, we think, included within the meaning and purpose of the statute permitting deduction in the case of oil and gas wells of a reasonable allowance for depletion according to the peculiar conditions in each case."

* * * * * * *

"The statute makes effective the legislative policy, favoring the discoverer of oil, by valuing his capital investment for purposes of depletion at the date of the discovery rather than at its original cost. *The benefit of it accrues to the discoverer* IF HE OPERATES THE WELL AS OWNER OR LESSEE, OR IF HE LEASES IT TO ANOTHER. IT WOULD BE AN ANOMOLY IF THAT POLICY WERE TO BE DEFEATED AND ALL BENEFIT OF THE DEPLETION ALLOWANCE WITHHELD BECAUSE HE CHOSE TO SECURE THE RETURN OF HIS CAPITAL INVESTMENT BY STIPULATING FOR A SHARE OF THE OIL PRODUCED FROM THE DISCOVERED WELL THROUGH OPERATION BY ANOTHER.

"The bonus received by the Smitherman partnership *was a return pro tanto of the petitioner's* CAPITAL INVESTMENT IN THE OIL, AN ANTICIPATION

OF ITS EXTRACTION, RESULTING IN A CORRESPONDING DIMINUTION OF THE UNIT DEPLETION ALLOWANCE UPON THE ROYALTY OIL AS PRODUCED."

The decision of the Circuit Court in effect restricting such depletion allowance on assignment of a lease to reservation of over-riding royalty, excluding consideration of the peculiar circumstances of this case and giving no effect to the decisions of the Supreme Court to the effect that:

> "The loss or destruction of the oil at any time from the date of the leases until complete extraction would have resulted in loss to—(the Smitherman partnership in that case—petitioner here).
>
> "Such an interest is, we think, included within the meaning and purpose of the statute permitting deduction in the case of oil and gas wells of a reasonable allowance for depletion according to the peculiar conditions in each case." *Palmer* v. *Bender, supra.*

and as said in *Anderson-Prichard* v. *Helvering,* 60 S. Ct. 952, with respect to the character of instrument involved in *Thomas* v. *Perkins,* 301 U. S. 655:

> "The decision did not turn upon the particular instrument involved, or upon the formalities of the conveyancer's art, but rested upon the practical consequences of the provision for payments of that type. See Palmer *v.* Bender, 287 U. S. 551, 555-557; Burnet *v.* Harmel, 287 U. S. 103, 111."

probably conflicts with the applicable principles set forth there.

In a solicitor's memorandum it was held that where a corporation which owned a coal leasehold acquired the remainder interest, it should capitalize that portion of the leasehold cost allocable to that portion of the original term

of the lease unexpired at the date of the acquisition of the remainder. The cost of the coal lands was the amount so capitalized plus the price paid for the remainder (Sol. Mem. 2931, IV-I C. B. 33, modifying Comm. Rec. 3240, II-2 C. B. 108), and such memorandum is an indication of the department's opinion as to what would constitute petitioner's capital investment in this case. See also *Henry Boos,* 30 B. T. A. 882.

The cases cited by the Circuit Court of Appeals, to-wit, *Commissioner* v. *Fleming,* 82 F. (2) 324; *Laird* v. *Commissioner,* 97 F. (2) 730; *Hammond* v. *Commissioner,* 106 F. (2) 420; *Helvering* v. *Elbe Oil Land Development Co.,* 303 U. S. 372, 58 S. Ct. 621, 82 L. Ed. 904; *Anderson* v. *Helvering,* 310 U. S. 404, 60 S. Ct. 952, 84 L. Ed. 1277, were cases where lessees disposed of all their interest in the oil and gas in place, leaving nothing to be depleted, but they re-assert the applicable principles contained in *Palmer* v. *Bender, supra,* and in other Supreme Court cases, which principles applied to the facts here disclose a conflict between such cases and the decision of the Circuit Court in this case, the conflict appearing not so much in failure to recognize the right to depletion where a depletable interest is retained, as in determination of whether under the peculiar conditions of each case there is such a retained interest, and in failing to apply the correct reasoning and broad policy set forth in such decisions in determining whether such interest is retained.

To illustrate, the ruling of the Board of Tax Appeals that the taxpayer had no depletable interest, in *Bankline Oil Company, Petitioner,* v. *Commissioner of Internal Revenue, Respondent* (33 B. T. A. 910) was reversed by the Circuit Court of Appeals for the Ninth Circuit (90 F. (2) 899) and because of an asserted conflict with the principles applicable under the decision of the Supreme Court, this

court granted certiorari. There the question was whether a processor of wet gas who claimed right by reason of its contracts to depletion of 27½ per cent of the difference between the price which it paid for wet gas and its fair market value at the mouth of the wells had a depletable interest. The Circuit Court of Appeals was of the opinion that respondent oil company had acquired an economic interest in the wet gas in place, but this Court held it had only an economic advantage; but because of the probable conflict with other cases on the question of retention of depletable interest certiorari was granted.

Again in *Helvering* v. *Elbe Land Development Co.*, 303 U. S. 372, likewise from the Ninth Circuit, there was also the conflict as to whether under the facts there was a retained interest depletable, and this Court granted certiorari, as is also the case in *Helvering* v. *O'Donnell*, 303 U. S. 370, 58 S. Ct. 619, where depletion on payments for stock from oil profits was involved, and on the issues in all these cases, the conflict arose from determination of the question of whether the facts disclosed a retention of a depletable interest. Petitioner here presents a probable conflict with the applicable decision of the Supreme Court on the same legal question, that is, under the peculiar conditions of its case petitioner claims retention of a depletable interest, and that the decision of the Circuit Court of Appeals that it did not retain such interest, probably conflicts with the applicable decisions of this Court heretofore cited.

Point II.

Summary:

The Circuit Court of Appeals erred in failing to give effect to a local rule of property which holds a reversionary interest in an oil and gas leasehold estate is a taxable interest in land.

Referable to the Question, and Reason V in the Petition, and Specification of Error IV in Brief:

Argument and Authorities under Point II:

The decision and holding of the Circuit Court of Appeals was to the effect that petitioner did not retain a depletable interest in the property sold. The petitioner owned ⅔rds of the reversion in the leasehold conveyed by the assignment, and retained same.

No doubt such "possibility of reverter" or inchoate right to the reversion of the working interest in the minerals is an interest in land in Texas. *Caruthers* v. *Leonard, Com. App.*, 254 S. W. 779, 782. Such a right can be deeded by its owner as an interest separate and apart from the surface rights or royalty. *Id.* Such inchoate reversionary right is conveyed by a general warranty deed to the land to which it is attached, even though it is not therein referred to *Robinson* v. *Jacobs*, 113 Tex. 231, 254 S. W. 309.

Petitioner, owning such interest in the working interest transferred, it was depletable, and the judgment of the Circuit Court in refusing depletion probably conflicts with the decision of this Court in *Palmer* v. *Bender*, and decides an important question of local law in a way probably in conflict with applicable local decisions.

Conclusion.

It is respectfully submitted that by reason of the importance to the oil industry as a whole of having the opinions of the courts in harmony with respect to the character of retained interest in minerals which will give character to a cash payment as a bonus or advance royalty, and the probable conflict of the decision of the Circuit Court in this case with the applicable decisions of the Supreme Court determining such question under the peculiar cir-

cumstances of this case, which presents a situation demanding determination of whether such interest was retained under a fact situation never before directly passed upon by the Supreme Court, but which should be determined, the Supreme Court of the United States should exercise its jurisdiction and grant a writ of certiorari in this cause to the United States Circuit Court of Appeals for the Fifth Circuit to review the judgment of that court entered on the 8th day of April, 1941, and that upon such review the judgment of said court be reversed and petitioner be allowed depletion as claimed.

Respectfully submitted,

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